



## Immediate Deductions Allowable for Sales-Based Royalties



In *Robinson Knife Manufacturing Co., Inc. v. Commissioner*, the U.S. Court of Appeals for the Second Circuit agreed with Hodgson Russ's client's position that royalty payments for using licensed trademarks in connection with sales of kitchen tools were immediately deductible. The court noted that the position taken by the IRS and the U.S. Tax Court would result in exactly the problem Congress enacted uniform capitalization rules under Internal Revenue Code Section 263A to fix.

Under the court's decision, where a producer's royalty payments are (1) calculated as a percentage of sales revenue from inventory and (2) are incurred only upon the sale of that inventory, they are immediately deductible. The court's decision, which is binding in the Second Circuit, provides legal authority for taxpayers and presents litigation risks for the IRS outside of the Second Circuit.

Treasury has repeatedly identified issuing regulations on the treatment of sales-based royalties as a priority project. If Treasury does issue such regulations, their validity would be subject to judicial review. Also, IRS interpretation of the regulations in specific cases would be subject to review. In *Robinson*, the Second Circuit determined that the interpretation of a relevant regulation by the IRS and the Tax Court was contrary to its plain meaning.

If the court had agreed with the IRS and the Tax Court that Robinson's royalty payments were not immediately deductible, the company would have been required to capitalize the costs by adding them to inventory. Some of the costs would have been capitalized to ending inventory and deductible only in later tax years. As a result, even though Robinson's royalty costs were based on sales of kitchen tools, and kitchen tools sold were clearly not in ending inventory, Robinson would have been required to capitalize the costs.

Any business that incurs sales-based royalties should consider the possible application of the court's holding that sales-based royalties that meet the requirements in the court's decision are immediately deductible.

Robinson was represented by a Hodgson Russ team led by Alice A. Joseffer, head of the firm's Tax Dispute Resolution Practice Group, and Robert J. Lane, Jr., who leads the Business Litigation Practice Group.

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